No. 14737

In the United States Court of Appeals for the Ninth Circuit

A. G. HOMANN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ANNA HOMANN, PETITIONER

v.

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

A. G. HOMANN, RESPONDENT

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ANNA HOMANN, RESPONDENT

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE COMMISSIONER

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BRIEF FOR THE COMMISSIONER

OPINION BELOW

The findings of fact and opinion of the Tax Court (R. 15-26) are not officially reported.

JURISDICTION

The petitions for review (R. 29, 31-32, 113-115, 116-118) involve deficiencies in income taxes determined

by the Commissioner against the taxpayers for 1946. On July 27, 1951, the Commissioner mailed the taxpayers notices of deficiencies in taxes for that year. (R. 7-12.) Within ninety days thereafter and on October 24, 1951,[1] the taxpayers filed petitions with the Tax Court of the United States for a redetermination of the deficiencies for 1946, under Section 272 (a)(1) of the Internal Revenue Code of 1939. The decisions of the Tax Court that there were deficiencies in income tax for 1946 were entered on March 1, 1955 (R. 27-28), and the cases were brought to this Court by petitions filed by taxpayers on March 31, 1955 (R. 29, 31-32) and by the Commissioner on June 21, 1955 (R. 113-115, 116-118). Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court's finding that the 68 houses in question were held primarily for sale to customers in the ordinary course of taxpayer's business within the meaning of Section 117 (a) and (j) of the Internal Revenue Code of 1939 was clearly erroneous.

2. Whether the Tax Court correctly decided that taxpayer's basis for the housing in question should not be reduced by an allowance for depreciation under Section 113 (b)(1)(B) of the 1939 Code.

3. Whether the Tax Court correctly decided that the gain received by the taxpayer on the disposition of various furnaces, ranges and refrigerators originally installed in the houses in question but later removed

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[1] Although this date does not appear in the printed record it is found in the record on review.

and sold, constituted long-term capital gain under Section 117 of the 1939 Code rather than ordinary income.

STATUTE AND REGULATIONS INVOLVED

The applicable statute and Regulations are set forth in the Appendix, *infra*.

STATEMENT

The facts as stipulated and as found by the Tax Court (R. 15-22) are as follows:

A. G. Homann, hereinafter called the taxpayer, and Anna Homann, his wife, resided in Olympia, Washington, a community property state, at all times material herein. They filed separate income tax returns for the years 1945, 1946 and 1947 with the Collector for the District of Washington. (R. 15.)

Taxpayer is a general contractor in Olympia, Washington. At the present time he maintains his office in Lacey, Washington, which is about four miles east of Olympia, Washington. Taxpayer has been engaged in the general contracting business for 30 years, and is a member of the Associated General Contractors of America. (R. 15.)

Taxpayer's contracting business is conducted by him, individually, under the name of A. G. Homann, General Contractor. No one else has any proprietary interest in his business. (R. 15.)

During World War II, taxpayer worked on war projects. Some time prior to July, 1944, the Hanford Engineering Works, hereinafter sometimes called Hanford, requested that 100 single dwelling homes be built to house 100 of its employees. Taxpayer first learned about the proposed project from some friends at the

Seattle regional office of the Federal Housing Authority, hereinafter referred to as F.H.A. After finding out about the project, taxpayer went to Sunnyside, Washington, and talked to a committee which had been formed to promote the construction of such houses. (R. 15-16.)

After investigating what he had heard, taxpayer agreed to proceed with the construction of the houses. In or about July, 1944, taxpayer started construction on 85 single dwelling houses in Sunnyside, Washington. Another contractor in Sunnyside built the remaining 15 houses desired by Hanford. (R. 16.)

Taxpayer constructed his houses on a tract of land land which he purchased, replatted and recorded as Homann's Addition to Sunnyside. At least 100 lots were purchased. F.H.A. required that the lot for each house be not less than 60 feet wide. Taxpayer's plat was submitted to F.H.A. and the houses were all approved by that agency. F.H.A. places a ceiling on borrowing in connection with its authorized projects. (R. 16.)

When taxpayer first learned about the project he was told that he could rent or sell only to Hanford employees. Early in the spring of 1945, Colonel Mathias, who was in charge of Hanford, advised taxpayer's representative, Beckwith, without previous warning, that the Hanford employees were to be moved to Oak Ridge, Tennessee, and that henceforth there would be no Hanford employees available to occupy the houses. None of the houses were ever rented or sold to Hanford employees. The houses were completed in the spring of 1945. Lawns and shrubs were put in later when the ground was dry enough to work. (R. 16-17.)

In order to finance this project, taxpayer had borrowed about $150,000 through Sherrill and Roberts, the lending agency for the project. Taxpayer paid approximately $20,000 for the land and his own investment in the project fluctuated between $20,000 and $60,000. The amount paid by taxpayer for the land and the labor met the minimum requirements necessary to obtain this loan. In May, 1944, taxpayer also borrowed $45,000 from the National Bank of Commerce in Olympia, Washington. (R. 17.)

The restrictions on renting and selling solely to the Hanford employees not being effective, taxpayer conducted a radio campaign over Station KIT in Yakima, Washington. This program lasted for two months and consisted of spot announcements. It was handled by Beckwith and taxpayer approved the plan. All of the houses were rented in 1945, before any sales were consummated. (R. 17.)

Taxpayer rented the houses on a month-to-month basis. There were no written leases. There were several oral agreements entered into whereby rent would be credited to the purchase price. These agreements amounted to a rental arrangement with an option to buy. All tenants who wanted to buy could have this arrangement. (R. 17.)

F. H. A. restrictions through the latter part of 1945 allowed up to 20 percent of its authorized housing to be sold. The balance had to be rented. Sixteen of taxpayer's houses, approximately 20 percent, were sold in 1945. Sixty-eight of the houses were sold in 1946, after removal of all F. H. A. restrictions on percentage of sales. Only one house remained unsold at the end of 1946. This house, the one occupied by Beckwith as an

officer, was sold in 1947, and a commission of $300 was paid on the sale. All of the houses were sold to individuals. Each purchaser refinanced his purchase, and the proceeds of his mortgage were used to retire the original mortgage loan. Sales were negotiated continuously throughout the years material herein, beginning in April, 1945. The sales were closed in groups at irregular intervals because the lending agencies which refinanced the purchases would not process individual mortgage loans, but required taxpayer to wait until a group could be accumulated. (R. 17-18.)

At all times material herein, the houses were under rent control. This restriction did not change by reason of the removal of the Hanford plant and the elimination of restrictions on public rental. (R. 18.)

Taxpayer has never built any houses on his own account which were sold to others except the houses in controversy herein. He has never had a real estate broker's license. He had never previously built houses on his own account for rental purposes. (R. 18.)

Horace Miller was a real estate agent in the town of Sunnyside during all years material herein, and served as taxpayer's agent in the handling of money transactions. Miller was not the only real estate agent in Sunnyside. Miller was to get a 5 percent commission for collecting and transmitting rents to taxpayer and a 2½ percent commission on the sale of the houses. He always had authority to sell the houses if he found a buyer. (R. 18-19.)

Miller took a deposit on the sale of a house in September, 1944. Miller had reason to believe that he was acting in taxpayer's behalf. (R. 19.)

Taxpayer reported the gain realized on the sale of

the 16 houses sold in 1945 as short-term capital gain. Taxpayer had been in doubt as to whether those houses had been held for the 6 months necessary to qualify for capital gains treatment. Those houses were all sold to people who purchased without solicitation. (R. 19.)

Sales of the 68 houses sold in 1946 were made to people who came in to purchase voluntarily. No "for sale" signs were ever displayed on any of the houses, and such advertisements were not carried in the newspaper. (R. 19.)

The town of Sunnyside doubled in population during the period in controversy and taxpayer's houses were selling without difficulty. At this time veterans of World War II were coming back and wanted homes. Most of the houses were sold to returning veterans. It was not necessary to put "for sale" signs up or to conduct a selling campaign. (R. 19.)

Miller kept separate account of the income from rentals and the income from sales after August 1, 1945. (R. 19.)

Taxpayer did not know how much activity was carried on by Miller in selling his 85 houses. Taxpayer's superintendent did not know how much sales activity was carried on by Miller. (R. 20.)

Beckwith was employed by taxpayer from 1941 until 1949 as an assistant and in this capacity he had charge of the houses and looked for prospective new business. He was the only employee retained permanently and he lived in one of the houses which served as his office. Beckwith received a weekly wage. (R. 20.)

The houses were relatively new when they were sold and few repairs were necessary in order to improve the marketability. (R. 20.)

After the houses were completed taxpayer went to the project no more than once every four or five months. (R. 21.)

The total cost of the 85 houses, according to the Sunnyside books, was $515,539.82. Taxpayer charged off $94,133.57 on the 1945 income tax return and $415,298.25 on the 1946 income tax return. On his 1946 income tax return, taxpayer also charged off the amount of $18,310.75 under the heading of expenses of sale and cost of improvements subsequent to acquisition. (R. 21.)

In taxpayer's 1945 individual income tax return the sales of the houses were listed under a schedule entitled short-term capital assets. Under the heading of "date acquired" the houses were listed as having been acquired July 1, 1945. Under the heading, "date sold," 15 of the houses were listed as having been sold September 1, 1945, and one house was listed as having been sold August 1, 1945. The respective gain on the sale of these houses in the amount of $10,306.43 was included in income as net short-term capital gain. On a schedule attached to taxpayer's 1945 income tax return the cost of the Sunnyside houses was shown at $500,533.57 (84 houses at $5,890 each and one house at $5,773.57). (R. 21.)

On taxpayer's 1946 individual income tax return the gain on the sale of the 68 houses was included under long-term capital gains and losses with the date sold being listed as October through December, 1946. (R. 21.)

In 1945, taxpayer's income from rents was $4,892.85. His income from sales of the houses was $10,306.43. Rental expenses totaled $9,606.53. Expenses included

interest, taxes, insurance and utilities, but nothing for depreciation or salary to Beckwith. (R. 21-22.)

In 1946, the income from rents showed a loss of \$1,034.25. Repairs were deducted in the amount of \$14,828.98 and other expenses totaled \$2,454.36. Income from sales in that year was \$20,050.98. (R. 22.) Taxpayer claimed no depreciation in 1946. (R. 38.)

The houses were originally equipped with refrigerators and ranges. Some occupiers owned their own refrigerators or ranges and did not desire to purchase or rent a house unless these items were removed. Many were removed and sold for salvage value. Taxpayer realized \$6,218.88 from the salvage of the refrigerators. (R. 22.) Some furnaces were defective and removed, \$325 was realized from their partial disposition on July 23, 1946, and \$350 on November 8, 1946. (R. 22.)

The Tax Court found that the taxpayer was never in the business of selling second-hand ranges, refrigerators or furnaces. (R. 22.)

The Tax Court also found that the houses which taxpayer sold in the taxable year 1946 were held primarily for sale to customers in the ordinary course of his business. (R. 22.)

STATEMENT OF POINTS TO BE URGED

1. The Tax Court erred in holding that since taxpayer held the property primarily for sale he would not qualify for the "use in trade or business" requirement of the depreciation deduction and also that the Commissioner erred in reducing taxpayer's basis on account of depreciation allowable.

2. The Tax Court erred in holding that the proceeds received by the taxpayer from the sale of furnaces, re-

frigerators and ranges, which appliances were originally installed in houses held primarily for sale to customers in the ordinary course of taxpayer's business, are taxable as capital gain rather than as ordinary income.

SUMMARY OF ARGUMENT

1. The principal question presented in these cases is whether the profit realized by taxpayer and his wife from the sale of the 68 houses in 1946 should be taxed as ordinary income or as capital gain. The profit should be taxed as ordinary income if the houses were held by the taxpayer primarily for sale to customers in the ordinary course of his business within the meaning of Section 117 (a) and (j) of the Internal Revenue Code of 1939. The Tax Court found that the 68 houses were held by the taxpayer primarily for sale to customers in the ordinary course of his business and therefore the gain realized on their sale was taxable as ordinary income. Whether the property was so held is, of course, a question of ultimate fact, no single circumstance being conclusive, and the Tax Court's finding to that effect should not be disturbed unless clearly erroneous. Therefore, we need only determine whether that finding is supportd by the record.

Taxpayer contends that he was in the business of building houses for rental. However, we submit that in the light cast by the Tax Court's application of the various guides, which have been helpful in like cases, it was fully warranted in finding that the taxpayer was engaged in the business of building houses for sale. It is clear that there is substantial evidence in the record that the 68 houses were held *primarily* for sale to customers in the ordinary course of taxpayer's business

within the meaning of Section 117 (a) and (j) of the 1939 Code.

2. The Tax Court erred in deciding that taxpayer's basis for the 68 houses should not be reduced by allowable depreciation under Section 113 (b)(1)(B) of the Internal Revenue Code of 1939. It is very clear that while the houses in question were held *primarily* for sale they were nevertheless also held until that time for the production of income (rentals). Thus the property falls within the ambit of Section 23(l)(1) and (2) of the Internal Revenue Code of 1939. Section 113 (b)(1)(B) of the 1939 Code provides that in arriving at the adjusted basis of property for the purpose of determining the gain or loss upon its sale taxpayers shall make an adjustment for depreciation to the extent allowed but not less than the amount allowable. Therefore, taxpayer's basis for the 68 houses should have been reduced by the appropriate depreciation.

3. The Tax Court also erred in holding that the proceeds received by the taxpayer from the salvage sale of furnaces, refrigerators and ranges were taxable as capital gain rather than as ordinary income. The record reveals that the aforementioned items were an integral part of the houses taxpayer built for sale, and must be considered as held primarily for sale to customers in the ordinary course of his business. Furthermore, since the gain resulting from the sale of the furnaces, ranges and refrigerators was derived from articles used in taxpayer's trade or business it is deprived of capital gains treatment and must be taxed as ordinary income.

ARGUMENT

I

There is Ample Evidence in the Record to Support the Tax Court's Finding that the 68 Houses in Question Were Held Primarily for Sale to Customers in the Ordinary Course of Taxpayer's Business Within the Meaning of Section 117(a) and (j) of the Internal Revenue Code of 1939

In 1946, the taxpayer sold 68 houses in Sunnyside, Washington. The taxpayer and his wife reported the profits realized from the sales in their separate returns for 1946 as long-term capital gain. Later the Commissioner determined deficiencies against the taxpayer and his wife for the year 1946 on the ground that the profits derived from the 68 houses constituted ordinary income rather than capital gain since the units were held primarily for sale to customers in the ordinary course of taxpayer's business. The taxpayer and his wife petitioned the Tax Court for a redetermination of the asserted deficiencies and that court found (R. 22):

> The houses which petitioner sold in the taxable year 1946 were held primarily for sale to customers in the ordinary course of petitioner's business.

The Tax Court thereupon concluded that the gain derived therefrom was properly treated by the Commissioner as ordinary income rather than capital gain. (R. 25.)

This Court has been confronted with the question of whether property was "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business," under subsection (a) and (j) of Section 117, Internal Revenue Code of 1939 (Appendix, *infra*), in an impressive array of cases. *Cohn*

v. *Commissioner,* decided October 1, 1955 (1955 C.C.H., par. 9674); *Stockton Harbor Indus. Co.* v. *Commissioner,* 216 F. 2d 638; *McGah* v. *Commissioner,* 210 F. 2d 769; *Jones* v. *Commissioner,* 209 F. 2d 415; *Palos Verdes Corp.* v. *United States,* 201 F. 2d 256; *McGah* v. *Commissioner,* 193 F. 2d 662; *Rollingwood Corp.* v. *Commissioner,* 190 F. 2d 263; *Rubino* v. *Commissioner,* 186 F. 2d 304, certiorari denied, 342 U.S. 814. Here the question to be decided is essentially one of fact and a trial court's finding that property was so held by a taxpayer is not to be disturbed unless clearly erroneous. *Cohn* v. *Commissioner, supra; Stockton Harbor Indus. Co.* v. *Commissioner, supra; Rollingwood Corp.* v. *Commissioner, supra; Rubino* v. *Commissioner, supra; Gensinger* v. *Commissioner,* 208 F. 2d 576 (C.A. 9th).

As this Court and others have often pointed out there is no fixed formula or rule of thumb for determining whether property sold by a taxpayer was held by him primarily for sale to customers in the ordinary course of his business. For each case, in the last analysis, must rest on its own peculiar facts. There are, however, certain factors which have been recognized as helpful guides in ascertaining the correct result. Among these are (1) the purpose for which the property was acquired, (2) the frequency and continuity of sales as opposed to isolated transactions, (3) the substantiality of the sale transactions and (4) the extent and substantiality of the sales income with respect to the rental income earned by the taxpayer. *Cohn* v. *Commissioner, supra; Victory Housing No. 2* v. *Commissioner,* 205 F. 2d 371 (C.A. 10th); *Mauldin* v. *Commissioner,* 195 F. 2d 714 (C.A. 10th). And, we submit, the Tax Court considered all of the aforementioned

criteria in arriving at its decision in the cases at bar.

In the cases under consideration the purpose for which the 85 houses were originally planned was for rent or sale to Hanford employees. (R. 16, 61.) However, such purpose was frustrated before the operation really began for the Hanford employees, who were to buy or rent the houses, were transferred to another part of the country. (R. 16.) While the foregoing stated purpose standing alone is inconclusive when considered along with taxpayer's subsequent conduct in disposing of the houses as fast as legally possible, it reveals that the houses were actually built for sale.[2] This conclusion, we submit, is inescapable when one considers, as did the lower court, the fact that although the construction of the houses was not finished until the spring of 1945, taxpayer sold as many of them as was permitted by the F.H.A. restrictions in that year, and, then when the sales restrictions were removed in 1946, disposed of all but one house which was occupied by taxpayer's assistant Mr. Beckwith, who was in charge of the Sunnyside project. (R. 17-18, 23, 84.) Indeed, the foregoing evidence completely negates any idea that the houses were erected as long range investment property and buttresses the position that the rental of the houses was merely incidental to their sale.[3]

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[2] Taxpayer testified (R. 71-72) that one house was tentatively sold in 1944 before the project was completed but that he was told by the Hanford people that this was wrong and the sale did not go through. Taxpayer also testified that he applied some rental payments to the purchase price of the homes. (R. 23-24.)

[3] This Court said in *Rollingwood Corp.* v. *Commissioner, supra* (p. 266):

> Suppose the taxpayer in the instant case intended to rent the houses for as long as he was required to do so under existing regulations and then to sell them. Or suppose his in-

As we have already pointed out the Tax Court's decision is fully supported both by the frequency and continuity of sales and the extent and substantiality of the sales transactions. For the houses in question were sold as fast as possible under the existing F.H.A. restrictions; 84 of the 85 houses were disposed of within 18 months and the project manager's residence soon thereafter.

Courts have sometimes given consideration to the existence or absence of an advertising campaign being carried on by the taxpayer. In *Rollingwood* v. *Commissioner, supra,* where there was no advertising and no "for sale" signs used, this Court said (p. 267):

> Petitioners insist that the sales were passive in that there were no "for sale" signs and no sales force. But the number of sales speak for themselves.

Here taxpayer testified (R. 65) that so many people tried to buy the houses that he could have sold them a dozen times over. He also said (R. 106) that "The houses were selling faster than we could get the renters out." As the Tax Court pointed out (R. 24) such a "considerable, continuous, and constant operation of sales was envisaged" that the assistant employed by the taxpayer was willing to accept a commission of only 2½ percent instead of the usual 5 percent.

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tention was to pursue whichever of these activities proved to be the most profitable, that is, if the *rental market* were good he would continue to rent but if the *sales market* were high he would sell. In either of these suppositions we think it is fair to say that one of the essential purposes (in acquiring or holding the houses) is the purpose of sale. Under such circumstances, if the taxpayer does dispose of the houses by sale, is it within the legislative *purpose* to allow them to treat the proceeds of these sales as a capital gain? We think not.

As we have seen, taxpayer's transactions were not only substantial in number but also from the standpoint of financial return. Although it is true that the "disparity between income from sales and from rentals is not controlling" (*Delsing* v. *United States*, 186 F. 2d 59, 61 (C. A. 5th), see *Cohn* v. *Commissioner, supra*), ordinarily a taxpayer whose primary interest in real estate is investment income, or rentals, would be expected to receive more income from rentals than from sales.

In the case at bar, the taxpayer received the following profits from sales and rentals (R. 21-22):

Year	Profit from Sales	Net Rentals
1945	$10,306.43	$ 4,892.85
1946	20,050.98	(-) 1,034.25
1947 [4]		

In 1945 and 1946, the taxpayer received $3,858.60 net rental income from the 85 houses. Taxpayer realized a profit of $30,357.41 from the sale of 84 of such houses. The ratio of profit from sales to total rental income from the houses is in excess of ten to one. The overwhelming ratio of sales income to rental income received by taxpayer from the houses shows quite conclusively that the houses were held *primarily* for sale to customers in the ordinary course of taxpayer's business and that their rental was only incidental thereto.

Taxpayer, however, in an obvious attempt to lift himself by his own bootstraps bases his argument on the contention (1) that during the taxable year involved here he was not only a general contractor but was also

[4] The one house sold in 1947 was occupied by taxpayer's assistant (R. 18) so no rent was received and there is nothing in the record that would show the profit arising upon its sale.

in the business of renting real property (Br. 12, 17), and (2) that the sale of the 68 houses in question was not voluntarily made but rather was necessitated by his creditor's demand that he liquidate his indebtedness. (R. 13.)

1. It is of course possible to be engaged in the conduct of more than one business (*Fackler* v. *Commissioner,* 133 F. 2d 509 (C. A. 6th)) and each case in the end must be judged on its own facts. Indeed, as this Court pointed out in the *Rollingwood* case, *supra* (p. 266), most cases dealing with the problem of whether property was held primarily for sale to customers in the ordinary course of a taxpayer's trade or business involve a situation where such taxpayer is engaged in some activity apart from his usual occupation and the question is whether that activity constitutes a business. The fact that taxpayer was in the contracting business (R. 15) is not inimical to the further fact that he was also in the business of building 85 houses and holding them for sale. He treated this project as any other building would do, i.e., after finishing the development he sold the houses as fast as permitted by the applicable F. H. A. restrictions; none of the homes were retained for rental once the applicable selling restrictions had expired. (R. 17-18, 23.) The critical question is whether the 68 houses here involved were held *primarily* for sale to customers in the ordinary course of the business taxpayer was then carrying on. And this question the Tax Court has resolved against him on the basis of substantial evidence. The fact that the houses involved were at one time temporarily rented on a month to month basis is of no consequence. Cf. *Rollingwood Corp.* v. *Commissioner, supra* (p. 266).

Moreover, the fact that taxpayer is presently renting space in a building in Olympia (R. 19-20) has no relevancy here (Br. 17). The record discloses (R. 19-20) that the building taxpayer erected for Midfield Packers was contracted for in the ordinary course of his business as a general contractor and that he only acquired title to that property on September 9, 1949, and finished its construction to protect his original investment. Thus, the fact that taxpayer subsequently rented the aforementioned premises should have no bearing on the instant case.

2. There is no merit whatsoever to taxpayer's argument (Br. 12-13, 14) that he was forced by creditors to sell the 68 houses. This is evidenced not only by a lack of any substantiating data in the underlying record but also by taxpayer's own testimony about which the Tax Court observed (R. 23, fn. 1):

> Petitioner testified that his working capital was frozen in the fall of 1945 and that he could not obtain further bank credit. In spite of this he makes much of the fact that throughout the year 1946 his salable assets upon which all selling restrictions had been removed were not in any way being pressed as a source of capital funds. We find it so difficult to reconcile these two statements that we have omitted any finding of fact based upon them.

Inasmuch as the issue here is a factual one and each case of this type must be decided on its own peculiar set of facts, it is not believed necessary or helpful to consider all the cases cited by the taxpayer. *Cohn* v. *Commissioner, supra.* However, we do note that taxpayer's reliance upon the decisions of this Court in the

McGah cases, *supra; Goldberg* v. *Commissioner,* 223 F. 2d 709 (C. A. 5th); and *Victory Housing No. 2* v. *Commissioner, supra,* is misplaced due to obvious factual differences. The *McGah* cases are distinguishable from the instant proceeding in that (1) there from the very inception of the partnership business the idea of constructing houses for rental purposes was the dominating and controlling motive; and (2) there the decision to sell the rental units was not voluntarily made but rather was the result of a bank's demand for payment of part of the money owed it by the taxpayer.

In *Goldberg* v. *Commissioner, supra,* it is of primary importance to note that the Tax Court found as a fact and the Court of Appeals agreed that the taxpayer bought the property for rental as residential property, and further that while the lower court thought that the nature of taxpayer's business later changed to selling houses the Fifth Circuit decided that the facts of record merely indicated a liquidation of capital. Also the fact that the taxpayer in *Goldberg* was in the rental business for four years before liquidating serves to distinguish that case from the instant one where taxpayer sold all the houses as soon as possible.

In the *Victory Housing* case, the taxpayer was not engaged in the business of constructing units for sale to customers as here, but rather from its very formation was in the housing rental business. Furthermore the taxpayer there retained some of the houses for rental after the sales restrictions expired thus giving a basis for the court's holding that it merely liquidated a portion of its capital assets which did not constitute a sale of property in the ordinary course of business.

As we have previously said, the question of whether or not property was held primarily for sale to customers in the ordinary course of taxpayer's business is a question of ultimate fact, each case being required in the last analysis to turn on its own peculiar facts. Furthermore, here it is not a question of whether one case can be distinguished from another but rather whether there is substantial evidence to support the Tax Court's finding that taxpayer held the 68 houses in question primarily for sale to customers in the ordinary course of his business.

Under the circumstances, it is clear that the Tax Court has not erred in this case. It considered the crucial question as being whether at the time of sale the taxpayer held the 68 houses involved *primarily* for sale to customers in the ordinary course of his trade or business within the meaning of Section 117(a) and (j) of the 1939 Code. Considering the attending facts and circumstances, the Tax Court was amply justified in finding that the taxpayer so held the houses and, accordingly, in deciding that the gain realized on their sale was taxable as ordinary income rather than as long-term capital gain.

II

The Tax Court Erred When It Decided that Taxpayer's Basis for the 68 Houses in Question Should Not be Reduced by Allowable Depreciation

Section 23(l) of the Internal Revenue Code of 1939 (Appendix, *infra*) provides for a deduction on account of the depreciation of property by stating that a taxpayer in computing net income may deduct from gross income a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business *or held*

for the production of income.[5] Section 111 of the Internal Revenue Code of 1939 (26 U. S. C. 1952 ed., Sec. 111) provides that in computing gain or loss from the sale or disposition of property the resulting gain or loss shall be the excess of the amount realized over the adjusted basis provided in Section 113 (b) of the 1939 Code (Appendix, *infra*). Section 113 (b)(1)(B) of the 1939 Code (Appendix, *infra*) provides that, in arriving at the adjusted basis of property, taxpayer shall make an adjustment for depreciation to the extent allowed but not less than the amount allowable. *Virginian Hotel Co.* v. *Helvering,* 319 U. S. 523, 525, rehearing denied, 320 U. S. 810; *Blackhawk-Perry Corp.* v. *Commissioner,* 182 F. 2d 319, 321 (C. A. 8th).

In spite of the foregoing sections of the 1939 Code, the Tax Court rejected the Commissioner's contention that the taxpayer's basis for the 68 houses should be reduced on account of depreciation by holding (R. 25)—

> respondent erred in reducing petitioner's basis on account of depreciation "allowable." Since we have concluded that from the inception petitioner held the property primarily for sale it would not qualify for the "use in trade or business" requirement of the depreciation deduction.

We, however, submit that, despite the aforementioned holding of the Tax Court, it is very clear that not only were the 68 dwellings held *primarily* for sale

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[5] It is important to note that the 68 houses here in question were exhaustible assets and therefore subject to depreciation under the income tax laws. *United States* v. *Koshland,* 208 F. 2d 636, 639-640 (C.A. 9th); *Commissioner* v. *Moore,* 207 F. 2d 265, 277 (C.A. 9th), certiorari denied, 347 U.S. 942.

to customers but also that up until the time of their disposal they were held "for the production of income" (rentals) and thus fall within the ambit of Section 23 (l) (2) of the 1939 Code (Appendix, *infra*), and should have been depreciated. Indeed, this Court in *Rollingwood* v. *Commissioner, supra* (pp. 265-266), stated that the fact of rental is not incompatible with a primary purpose of sale. See also *Palm Homes, Inc.* v. *Commissioner,* decided January 17, 1952 (1952 P-H T. C. Memo. Dec., par. 52,008).

It has consistently been the practice of the Commissioner to allow depreciation where, as here, property has been rented even though the renting was essentially temporary and the property was held primarily for sale to customers in the ordinary course of a taxpayer's business. *Rubino* v. *Commissioner,* decided December 28, 1949 (1949 P-H T.C. Memorandum Decisions, par. 49,288) affirmed, *per curiam,* 186 F. 2d 304 (C.A. 9th), certiorari denied, 342 U.S. 614; *A. L. Carter Co.* v. *Commissioner,* 143 F. 2d 296, 297-298 (C. A. 5th); *Black* v. *Commissioner,* 45 B.T.A. 204. Therefore, we submit that the Tax Court clearly erred when it refused to require the taxpayer to reduce the basis of the houses sold in 1946 by the allowable depreciation.

III

The Tax Court Erred in Holding that the Proceeds Received by the Taxpayer from the Sale of Furnaces, Refrigerators and Ranges for Salvage Were Taxable as Capital Gain Rather Than as Ordinary Income

Taxpayer equipped the 85 houses constructed in Sunnyside, Washington with furnaces, refrigerators and ranges. The furnaces however proved defective and so were removed and replaced by taxpayer with oil furnaces; the old furnaces were scrapped and taxpayer realized $650 from the sale of their usable parts. Some of the tenants and purchasers of taxpayer's houses owned their own ranges and refrigerators and did not desire to purchase or rent a house unless these items were removed. Taxpayer complied with their wishes and removed the unwanted ranges and refrigerators which he sold as second hand for $6,218.88. (R. 22, 54-56, 90-91.) The record, outside of taxpayer's self-serving declarations (R. 55-56) does not reveal that any adjustments were ever made to the cost basis of the houses and the receipts garnered from the sale of the furnaces, ranges and refrigerators in 1946 were never closed to profit or loss. Therefore, the Commissioner treated those omitted receipts as additional ordinary income for 1946.[6]

The Tax Court however found (R. 22) that the taxpayer was never in the business of selling second-hand furnaces, ranges or refrigerators and held (R. 26):

> In placing some of the properties in proper condition it apparently became necessary for peti-

[6] It can safely be assumed that pursuant to usual business practices the original cost of the furnaces, ranges and refrigerators was treated as a part of the construction cost of the homes with taxpayer receiving credit for them when he charged off the allocated building costs on his returns for 1945, 1946, and 1947. (R. 55.)

> tioner to remove some furnaces, ranges and refrigerators. These were subsequently sold for their salvage value and respondent insists that this income also is ordinary income and not capital gain. We are unable to agree.
>
> Whatever petitioner's business as builder, developer and seller of finished houses, he was not in the business of selling used or secondhand equipment. These items were not held for sale in the ordinary course of petitioner's business.

Section 117 (a) of the 1939 Code defines capital assets to mean "property held by the taxpayer (whether or not connected with his trade or business) * * *." Standing alone, this broad definition would also include property purchased for the purpose of resale. But the statute limits the breadth of the definition by excluding certain classes of property from being considered as capital assets among which are: (1) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year; (2) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; and (3) property used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23 (l), or real property used in his trade or business, and which falls in classes (1) and (2).

In view of the Tax Court's finding (R. 22) that the houses erected by taxpayer in Sunnyside were held primarily for sale in the ordinary course of his business it is submitted that the furnaces, refrigerators and ranges, initially being an integral part of the houses, were unquestionably purchased and held for sale. And

it also seems clear that the disposal of the furnaces, refrigerators and ranges did not constitute a new business but was merely an adjunct of the business of selling the houses. Cf. *Nuta* v. *Commissioner,* decided September 24, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,283). Indeed the present situation is analogous to that faced daily by department stores which sell defective material or returned merchandise at reduced prices—the gain or loss from such sales being treated as ordinary income. Therefore, the furnaces, refrigerators and ranges were in all essential respects a part of taxpayer's stock in trade held for sale and the gain realized by taxpayer on their sale should be taxable as ordinary income rather than as capital gain.

In essence, this has been the view taken by this Court. In *Fidler* v. *Commissioner,* decided March 1, 1955 (1955 C.C.H., par. 9263), the taxpayer was required to treat the loss sustained on the sale of certain literary properties owned by him as a capital loss rather than as an ordinary loss on the basis that (1) he did not purchase the properties for use in his business; (2) he made an investment in the literary properties with the hope of selling them at a profit; and (3) he did not hold them primarily for sale to customers in the ordinary course of his trade or business or show that they constituted stock in trade or property of a kind which would properly be included in inventory. Here, using the very same reasoning, it is readily apparent that taxpayer purchased the property in question for use in his business, always expected to realize a profit from their sale and held them prior to their removal primarily for sale to customers in the ordinary course

of his trade or business as an integral part of the houses. Moreover, after their removal he did not modify his intention to dispose of them. This is conclusively shown in the fact he did actually sell them as salvage.

In *Grace Bros.* v. *Commissioner,* 173 F. 2d 170, this Court held (pp. 178-179) that taxpayer's liquidation of stock in trade did not convert it into a capital asset. And in *Commissioner* v. *Boeing,* 106 F. 2d 305 (C.A. 9th), certiorari denied, 308 U.S. 619, it was held immaterial that a taxpayer, engaged in the sale of cut logs from lands owned by him, was motivated by a desire to liquidate his investment. The gain resulting from such sales—being from his "trade or business"—was ruled ordinary income.

Since the furnaces, refrigerators and ranges sold by the taxpayer in the instant case were held primarily for sale to customers as a part of his business of disposing of the houses they are clearly denied treatment as capital assets by Section 117(a) of the 1939 Code, and the gain resulting from their sale must be considered ordinary income. *Richards* v. *Commissioner,* 81 F. 2d 369, 373 (C.A. 9th).

CONCLUSION

We submit that the decision of the Tax Court, in so far as it held that the 68 houses were held primarily for sale to customers in the ordinary course of taxpayer's business is correct and should be affirmed by this Court. On the other hand, we submit that that portion of the lower court's decision holding (1) that taxpayer's basis for the 68 houses should not be reduced for allowable depreciation; and (2) that the receipts from the sale of the furnaces, ranges and refrigerators

should be treated as capital gain is clearly erroneous and should be reversed by this Court.

Respectfully submitted,

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November, 1955

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income * * * from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) [as amended by the Revenue Act of 1942, c. 619, 56 Stat. 798, Sec. 121 (c)] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or
(2) of property held for the production of income.

In the case of property held by one person for life with remainder to another person, the deduction

shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

* * * * *

(b) [as amended by Sec. 130 (b), Revenue Act of 1942, *supra;* Sec. 204 (b), Revenue Act of 1950, c. 994, 64 Stat. 906; and Sec. 1, Act of July 14, 1952, c. 741, 66 Stat. 629] *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for taxes or other carrying charges, or for expenditures described in section 23 (bb), for which deduc-

tions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(i) allowed as deductions in computing net income under this chapter or prior income tax laws, and

(ii) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this chapter (other than subchapter E), subchapter E of chapter 2, or prior income, war-profits, or excess-profits tax laws,

but not less than the amount allowable under this chapter or prior income tax laws. Clause (ii) of this subparagraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under subsection (d). Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(C) in respect of any period prior to March 1, 1913, for exhaustion, wear and tear, obsoles-

cence, amortization, and depletion, to the extent sustained;

*   *   *   *   *

(26 U.S.C. 1952 ed., Sec. 113.)

SEC 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1);

*   *   *   *   *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, *supra,* and amended by Sec. 127 (b) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or

business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Such term also includes timber with respect to which subsection (k)(1) or (2) is applicable.

*   *   *   *   *

(26 US.C. 1952 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(l)-1. *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business, or treated under section 29.23(a)-15 as held by the taxpayer for the production of income, may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the

salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property determined in accordance with section 113. * * *

Sec. 29.117-1. *Meaning of Terms.*—The term "capital assets" includes all classes of property not specifically excluded by section 117(a)(1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23(1) and of real property used in the trade or business of a taxpayer is limited to such property used by the taxpayer in the trade or business at the time of the sale, exchange, or involuntary conversion. Gains and losses from the sale or exchange of such property are not subject to the percentage provisions of section 117(b) and losses from such transactions are not subject to the limitations on losses provided in section 117(d), except that under section 117(j) the gains and losses from the sale or exchange of such property held for more than six months may be treated as gains and losses from the sale or exchange of capital assets, and may thus be subject to such limitations. See sections 29.117-7. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23(1) prior to its amendment by the Reve-

nue Act of 1942. However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the limitations of section 117(b), (c), and (d). The term "ordinary net income" as used in these regulations for the purposes of section 117 means net income exclusive of gains and losses from the sale or exchange of capital assets.

*   *   *   *   *

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